Affinity
Federal Credit Union

Denise B. McGlone
Executive Vice President
Chief Financial Officer
73 Mountain View Blvd.
Basking Ridge, NJ 07920
908.860.3903 Direct
908.860.3885 Fax
denisem@affinityfcu.com

May 23, 2011

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Ms. Rupp:

Summary

Affinity Federal Credit Union welcomes the opportunity to comment on the NCUA proposed rule governing Interest Rate Risk (IRR). [1] Affinity applauds the recommendation that all FICUs maintain a written Interest Rate Risk Policy. Identifying, measuring, monitoring and controlling IRR is important for all financial institutions and critical for those entities with concentrations of long term fixed rate assets—especially given the low interest rates that have existed over the past few years.

The fundamental principles proposed in the amendment to 12 CFR Part 741 are consistent with: the January 6, 2010 interagency Advisory on Interest Rate Risk Management; Chapter 13, Part 2 of the Examiners Guide titled ALM-Interest Rate Risk; and regulatory guidance from the Federal Deposit Insurance Corporation, Federal Reserve Board, Comptroller of the Currency and Office of Thrift Supervision. In addition, Appendix B to Part 741 provides useful guidance regarding the components of what should be in an effective IRR policy.

Affinity appreciates NCUA's recognition that it is impossible to establish specific regulatory requirements for IRR that would be appropriate for all FICUs and that IRR management involves the credit union's board and management's judgment regarding each credit union's mission, structure and circumstances.

However Affinity believes that:

- Regulation is not necessary as existing guidance and exam procedures provide NCUA with ample authority;

---

[1] Federal Register/Vol. 76, No. 57/Thursday March 24, 2011/Proposed rules

- Certain items in Appendix B are onerous and could lead to ill-advised regulatory actions and/or meddling with the role of the credit union board of directors and management;
- Regulatory action based on simulation results is inherently flawed;
- The proposed regulation is designed to inhibit credit unions from holding long term mortgages on the balance sheet even if the CU is adept at managing such risk. Depriving CUs of earning assets will constrain their ability to grow capital.

Regulators should ensure that credit unions have robust IRR policies, sound internal controls, can support their IRR strategy and have effective tools to identify, monitor, measure and control IRR. Within that context, regulators must provide CUs with sufficient flexibility to manage the business.

We believe that general guidance is meant to be a tool that can support ongoing efforts by regulators and supervisors to achieve a more durable financial system. However, it is not meant to substitute or be restrictive to the more focused, micro-prudential principles of managing credit unions. We are concerned that overzealous and inconsistent application of the proposed regulation could inhibit credit union's ability to manage its business, serve members and grow capital.

Regulation vs. Guidance

As noted in the March 24, 2011 Federal Register NCUA believes that credit unions are generally managing IRR adequately. Further, the proposed rule will likely affect only 800 credit unions that may or may not have an existing written policy. Affinity does not see the necessity for adopting regulation for IRR as:

- Best practice is well documented in the Examiners Guide and is a critical part of every exam;
- The proposed regulation is essentially the same as the guidance contained in the Examiners Guide (except for example limits); thus, NCUA does not need to go beyond the governance that exists today;
- The proposed regulation will likely affect only 800 institutions. Additional regulation that affects only 800 institutions is a diversion at a time when the future of the movement is at risk. IRR policies and procedures should be addressed during the exam process for these institutions;
- Governing IRR through regulation may be inconsistent with other federal regulators that normally employ the exam process and guidance to address the effect of IRR on safety and soundness.

Unnecessary and overly prescriptive regulation of credit unions relative to other depository institutions could result in member uncertainty, jeopardize the stability of the CU deposit base, introduce liquidity, earnings and capital risk into the system and put credit unions at a disadvantage.

Appendix B to Part 741

Certain provisions in Appendix B raise questions. Section VII, Standards for IRR Assessment of IRR Policy and Effectiveness of Program, notes that risk limits must be appropriate to the size and complexity of the credit union. If the limit is unreasonable (i.e. limits allow measures to approach dangerously low levels under plausible interest rate scenarios), it is considered inadequate. This requirement is subject to interpretation. What happens if the examiner decides that a limit in a worst case scenario is "unreasonable"? Unreasonable could be defined differently by different examiners. What is the definition of plausible interest rate scenarios? One can note the variations in Economist's forecasts to determine that "plausible" is not easily determined.

There is concern about the implications associated with the limits identified in the proposed rule relative to the limits in Chapter 13 of the Examiner Guide. The proposed regulation indicates IRR policy limits should maintain risk exposures within prudent levels and provides an "example" of limits that is vastly different from the "example" in Chapter 13-Part 2 of the Examiners guide.

The following chart contrasts the differences:

Basis of Measurement		**"Example" in Proposed Rule**	**"Example" in Examiner Guide**
GAP	Change in any given period or cumlatively over 12 months	Less than +/- 10%	Less than +/- 20%
Income Simulation	Net Interest Income after schock change over any 12 month period	Less than 20%	Less than 30%
Book Value Net Worth and Net Economic Value	After schock market value of net worth	Greater than 6%	Greater than 4%
	After schock change in book value and market value of Net Worth	Less than 25%	Less than 50%

These limits suggest that a credit union might be required to have 50% more market value of net worth (4% vs. 6%) under the proposed rule and significantly less volatility in Net Interest Income and Net Economic Value relative to the limits contained in the Examiner Guide. Examiners often view the example limits as floors. Many do not consider individual business models and understand the limitations of asset liability simulation models in their determination of safety and soundness. Suggesting that 6% in the worst case simulation might be a floor when the current guide indicates that 6% in the worst case represents low exposure is a sudden change in posture that could have unintended consequences. Knee jerk reactions to simulation results could lead to poor decisions. Decisions to immediately sell assets, quickly reduce expenses, increase fees, limit mortgage lending should be based on significantly more variables than compliance with simulation results from a model. Basing regulation on simulations and forcing credit unions to take action on simulation results interferes with credit union operations.

Limitations of Asset Liability Simulation Models

Asset liability simulations models are based on hundreds of variables and the results are just one piece of information that guides interest rate risk mitigation. Although simulation results provide an important source of information to assess risk and take action, they are based on a staggering number of assumptions and merely provide a range of potential outcomes for a specific balance sheet at a particular point in time. Institutions intentionally stress the model with scenarios that have various probabilities of ocurring.

Examiners often place too much emphasis on the importance of simulation results and "suggest" actions that management should take to maintain a certain camel rating. Careful consideration regarding probabilities associated with worst case scenarios and recognition that simulations have limitations are ignored.

Limits Real Estate Lending

The proposed regulation is designed to prevent credit unions from holding concentrations of fixed rate mortgages at a time when members need the product. Further, the NCUA provides only 2 mechanisms to reduce risk—selling loans and borrowing term funds. NCUA policies regarding interest rate derivatives obstruct a credit union's ability to use this essential risk management tool. NCUA's posture regarding interest rate derivatives actually increases risk to the system.

Conclusion

Building capital at this point in time is challenging given the impact of: increasing provision expenses, continued assessments, regulations affecting operating income, minimal loan growth opportunities and increasing cost of compliance. Credit unions that effectively manage their interest rate exposures should be given the latitude to set limits, take calculated risk and determine the timing and method of hedging such risk.

Imposing more restrictive guidelines on CUs while at the same time extracting capital through additional assessments could threaten the movement; particularly if examiners are robotic in their interpretation and application of the proposed regulation. Additionally, NCUA's restrictions on the use of simple interest rate risk hedging tools impede credit unions from hedging the very risk that NCUA believes they need to regulate.

Adopting existing guidance into regulation appears to be another mechanism that will provide NCUA with the authority to be overly prescriptive regarding credit union operations. This is contrary to what credit unions and the system need at this time. Careful and judicious regulation is more critical than ever in today's economic environment.

Sincerely,

AFFINITY FEDERAL CREDIT UNION

Denise B. McGlone

Denise B. McGlone
Executive Vice President
Chief Financial Officer